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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

No. 659
No. 660

MOLONEY ELECTRIC COMPANY, *Petitioner,*

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

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PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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IN THE

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No. ———

No. ———

MOLONEY ELECTRIC COMPANY, *Petitioner,*

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

Your petitioner, Moloney Electric Company, prays that writs of certiorari issue to review the judgment of the Circuit Court of Appeals for the Eighth Circuit in cases No. 11,913 and No. 11,921, consolidated and decided June 9, 1941, rehearing denied June 27, 1941. The Eighth Circuit in part affirmed the United States Board of Tax Appeals and in part reversed the Board.

Opinions Below.

The opinion of the Board of Tax Appeals (R. 15) is reported in 42 BTA 78. The dissenting opinion pertinent to

this petition (R. 29) is reported in 42 BTA at page 88. The opinion of the Circuit Court of Appeals (R. 106) is reported in 120 Fed. (2d) 617.

Jurisdiction.

The jurisdiction of this Court is invoked under the provisions of Section 1141 of the Internal Revenue Code, and Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented.

1. Does the second sentence of Section 26(c), paragraph (2) of the Revenue Act of 1936, providing that

> "For the purposes of this paragraph a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits."

sufficiently broaden the phrase "within the taxable year" contained in the first sentence of said paragraph to embrace within its scope a contract requiring the setting aside of 20 per cent of the earnings in excess of $320,000, such earnings to be determined from an audit but in no event later than the first of April of the succeeding year, for the reason that a percentage of the earnings cannot be determined until the earnings are determined, and the earnings cannot be determined until the taxable year has elapsed;—or, can the said second sentence be given its full legal effect without having the payment or setting aside take place after the taxable year has closed?

2. Does a contract which expressly deals with the disposition of earnings and profits of the taxable year, but requires the payment of a sum equal to 2 per cent of the debt irrespective of earnings and profits fail to satisfy the requirements of Section 26(c)(2) of the Revenue Act of 1936 because such partial payment of the debt is payable in any

event, or does the said section require that the payment of the debt be solely dependent on earnings and profits?

Statute Involved.

Revenue Act of 1936 (49 Stat. 1664).

"Sec. 26. Credits of Corporations.

"In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

"(c) Contracts Restricting Payment of Dividends.

* * * * *

"(2) Disposition of Profits of Taxable Year.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936.

* * * * * "

Statement.

These causes arise in the determination of petitioner's income tax liability for the year 1936.

In the petition before the Board of Tax Appeals for a redetermination of the Commissioner of Internal Revenue's proposed deficiency, your petitioner claimed that in computing the surtax on undistributed profits imposed by the Revenue Act of 1936 it was entitled to the following credits under Section 26(c)(2):

(1) $13,810.00 representing 2% on the largest amount of bonds outstanding during the year; and

(2) $31,526.66 representing 20% of the earnings in excess of $320,000.

The Board sustained your petitioner on the first point, (R. 27-29) and decided against your petition on the second point, (R. 25-27), although there were three dissents thereto, (R. 29).

The Commissioner of Internal Revenue appealed the first point to the Eighth Circuit (No. 11,913) and the taxpayer appealed the second point (No. 11,921). Both appeals were consolidated and the Eighth Circuit decided both points for the Commissioner, (R. 106), (120 Fed. (2d) 617). Rehearing was denied on June 27, 1941 (R. 115).

On July 1, 1928 the taxpayer issued bonds due June 1, 1943 in the aggregate principal amount of $1,500,000 (R. 106). The trust indenture entered into in connection with the issuance of these bonds contained an article (Art. III, Sec. 1) expressly dealing with the disposition of earnings and profits (R. 68) and required the taxpayer to pay to the trustee on June 1, 1936 "a sum equal to 2% of the largest amount of debenture bonds at any time outstanding." The taxpayer was also required to set aside not later than the first of April, and pay to the trustee not later than June 1st, 20 per cent of the earnings for the next preceding year, of the Company in excess of $320,000 (R. 68-69).

Bonds in the aggregate principal amount of $690,500 were outstanding at the beginning of the taxable year 1936. (R. 22). They were all retired during that year. (R. 22). Two hundred and forty thousand dollars of its earnings for 1936 was used in liquidating its bonded indebtedness. (R. 28).

The Board of Tax Appeals in deciding the issues held that Article III of the indenture "does expressly deal with the disposition of earnings and profits of the taxable year" and allowed credit for 2 per cent of $690,500, or $13,810, (R. 29), but held that the 20 per cent of the earnings in excess of

$320,000 provision dealt with earnings of the preceding year rather than with those of the current year (R. 26).

The Eighth Circuit reversed the Board on the 2 per cent point, holding that "A contract which requires a payment irrespective of earnings and profits cannot be said to deal expressly with the disposition of earnings and profits of the taxable year.", (R. 109); and sustained the Board on the second point, (R. 111-112) but a reading of the opinion discloses that the Court gave no consideration to the effect the second sentence of Section 26(c)(2) of the Revenue Act of 1936 has on the phrase "within the year", as is indicated by the partial quotation in the opinion (R. 108). It is self-evident that a percentage of earnings cannot be determined until the earnings are determined, and the earnings cannot be determined until the taxable year has closed.

Specification of Errors to be Urged.

The Circuit Court of Appeals erred:

(1) In holding that the contract dealt with earnings of the preceding year, instead of the current year, disregarding the fact that earnings on a percentage basis can only be determined after the taxable year has closed.

(2) In failing to give effect to the second sentence of Section 26(c)(2), which expressly covers and includes contracts based on a percentage of earnings and profits.

(3) In sustaining the Board of Tax Appeals on the issue of a percentage of earnings.

(4) In holding that a contract which requires a payment irrespective of earnings and profits cannot be said to deal expressly with the disposition of earnings and profits of the taxable year, thereby failing to recognize that to be a debt it must be payable in any event.

(5) In failing to hold that the 2 per cent payment was a payment under a contract which "expressly deals with the disposition of earnings and profits of the taxable year."

(6) In failing to sustain the Board of Tax Appeals on the 2 per cent issue.

Reasons for Granting the Writs.

These cases present an important question of Federal law which has not been, but should be, settled by this Court.

There are four cases now pending in the Sixth Circuit, all of which involve the application of the second sentence of Section 26(c)(2) of the Revenue Act of 1936, and unless certiorari is granted your petitioner may suffer irreparable injury should the Sixth Circuit reverse the Board, thereby creating a conflict between the Sixth and Eighth Circuits. The cases there pending are:

Strong Manufacturing Co., (41 BTA 1273);
Warren Tool Co., (Memo BTA June 17, 1940);
Ohio Leather Co., (Memo BTA June 13, 1940);
Michigan Silica Co., (41 BTA 511).

All are appealed by the Commissioner of Internal Revenue.

The Circuit Court of Appeals entirely disregarded the most pertinent part of the law in deciding the issue regarding the percentage of earnings. The decision not only contains no discussion of the second sentence of Section 26(c)(2), but its entire disregard of said sentence is indicated by the quotation of the Act (R. 108) which stops just short of the said second sentence.

In deciding the 2 per cent point the Court of Appeals entirely overlooked the fact that to be a debt it must be payable in any event; otherwise, the interest would be that of a partner or stockholder; and credits under Section 26(c)(2) can only be granted if they relate to a discharge of a debt.

Conclusion.

For the foregoing reasons, it is respectfully submitted that this petition should be granted, commanding the Circuit Court of Appeals for the Eighth Circuit to certify and send to this Court full and complete transcripts of the rec-

ord and all proceedings in the cases entitled and numbered on its docket, *Guy T. Helvering, Commissioner of Internal Revenue* v. *Moloney Electric Company,* No. 11,913; and *Moloney Electric Company* v. *Guy T. Helvering, Commissioner of Internal Revenue,* No. 11,921 to the end that the said cases may be reviewed and determined by this Court as provided by law, and that petitioner may have such action and further relief in the premises as to this Court may seem proper.

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Of Counsel:
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September 26, 1941.

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In the Supreme Court of the United States

OCTOBER TERM, 1941

Nos. 659 and 660

MOLONEY ELECTRIC COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 15–29) is reported in 42 B. T. A. 78. The opinion of the Circuit Court of Appeals (R. 105–113) is reported in 120 F. (2d) 617.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on June 9, 1941. (R. 113–114.) A petition for rehearing was filed June 20, 1941 (R. 115–117) and denied June 27, 1941 (R. 119). The petition for a writ of certiorari was filed Sep-

tember 27, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. A trust agreement contained a provision requiring the taxpayer corporation to pay to the trustee for sinking fund purposes on a specified date each year a sum equal to 2% of the largest amount of debenture bonds at any time outstanding. The question in No. 659 is whether the provision "expressly deals with the disposition of earnings and profits of the taxable year" within the meaning of Section 26 (c) (2) of the Revenue Act of 1936.

2. The trust agreement also contained a provision requiring the taxpayer to pay to the trustee for sinking fund purposes 20% of its net earnings for the preceding year in excess of a specified sum, the amount due to be determined and forthwith set aside at the close of each calendar year and no later than April 1 and to be paid thereafter on June 1. A question in No. 660 is whether this provision required the amount to be paid or set aside "within the taxable year" as specified in Section 26 (c) (2). A further question is whether there was evidence that the taxpayer in retiring the bonds which were outstanding in the taxable year paid any portion of the amount because required to do so under the agreement.

STATUTE AND REGULATIONS INVOLVED

Section 26 of the Revenue Act of 1936 (49 Stat. 1648) provides:

> In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—
>
> * * * * *
>
> (c) *Contracts Restricting Payment of Dividends.*—
>
> * * * * *
>
> (2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. * * *
>
> * * * * *

Other provisions of the Act are set forth in the Appendix, *infra,* pp. 11–13, together with the pertinent Treasury Regulations.

STATEMENT

On June 1, 1928, the taxpayer, Moloney Electric Company, issued bonds due June 1, 1943, in the

aggregate principal amount of $1,500,000 (R. 20). The trust indenture (R. 65–95) entered into in connection with the issuance of these bonds required the taxpayer to pay to the trustees for sinking fund purposes on the first day of June, 1930, and on the first day of each succeeding June "a sum equal to 2% of the largest amount of debenture bonds at any time outstanding". The taxpayer was also required for sinking fund purposes on the first day of June, 1930, and on the first day of each succeeding June to pay to the trustee 20% of the net earnings of the company for the next preceding year in excess of $320,000 (R. 21). The following are the pertinent provisions of the trust agreement (R. 68–69, 71):

ARTICLE III.

> SECTION 1. The Company covenants that as a sinking fund for the retirement of debenture bonds issued hereunder it will pay to the Trustee on the first day of June, 1930, and the first day of each succeeding June thereafter, so long as any of the debenture bonds hereby authorized are outstanding, a sum equal to 2% of the largest amount of debenture bonds at any time outstanding, and will also pay on said date to the said Trustee 20% of the net earnings, for the next preceding year, as hereinafter defined, of the Company in excess of Three Hundred Twenty Thousand Dollars ($320,000). The determination of the sum to be paid to the sinking fund from

the net earnings shall be made from an audit to be made at the close of each calendar year by a firm of certified public accountants acceptable to the Trustee, and when said net earnings are so determined from said audit, which, in no event, shall be later than the first day of each April, said amount shall forthwith be set aside in a separate fund by the Company and shall be paid to the Trustee as herein provided on the first day of June of each year, beginning in the year 1930.

* * * * *

SECTION 3. The Company may, at its option, at any time redeem all or any part of the debenture bonds then outstanding hereunder. Such redemption shall be upon thirty (30) days' published notice as hereinabove provided, and at the price of One Hundred and Three Dollars ($103.00), and accrued interest to date of redemption, for each debenture bond.

* * * * *

Bonds in the aggregate principal amount of $690,500, were outstanding at the beginning of the taxable year 1936. They were all retired during that year. (R. 22.)

In the petition before the Board of Tax Appeals for a redetermination of the Commissioner's proposed deficiency assessment for the year 1936, the taxpayer claimed that in computing the surtax on undistributed profits imposed by the Revenue Act of 1936 it was entitled to a credit under

Section 26 (c) (2) of $13,810 (R. 7). This amount is 2 per cent of $690,500, which was the largest amount of the taxpayer's bonds at any time outstanding during the year 1936. This claim was sustained by the Board (R. 29) and is the issue with respect to which the Commissioner sought review in the court below (R. 35–40).

In its petition for redetermination before the Board, the taxpayer claimed a further credit under Section 26 (c) (2) of $31,526.66 (R. 7). This amount is 20 per cent of $157,633.31, the alleged net earnings for the year 1936 in excess of $320,000. This claim was overruled by the Board (R. 27) and is the issue with respect to which the taxpayer sought review (R. 43–48).

The court below sustained the Commissioner in both cases, and accordingly reversed in part and affirmed in part the decision of the Board of Tax Appeals (R. 113–114).

ARGUMENT

The decision of the court below is correct in both cases and there is no conflict or other reason for review.[1] Contrary to petitioner's assertion (Pet. 6), the cases do not present any important

[1] No conflict is alleged by petitioner. The possibility that the Circuit Court of Appeals for the Sixth Circuit, in one or more of the four cases cited (Pet. 6) by petitioner as now pending before it, might render a decision in conflict with those of the court below constitutes no ground for granting or postponing disposition of the petition herein.

issue of Federal law which this Court should determine. They merely involve claims to credits in the computation of the surtax imposed by the Revenue Act of 1936 upon undistributed corporate profits, and their outcome turns, not on any new or far-reaching principle of law, but on the particular facts.

1. The claim involved in No. 659 is that to a credit of $13,810, representing 2% of the largest amount of debenture bonds outstanding in 1936. The court below held (R. 109–111) this claim invalid for the reason that no portion of the payment for the retirement of the bonds was required by a contract provision which, as specified in Section 26 (c) (2), "expressly deals with the disposition of earnings and profits * * *." This holding was plainly correct. The trust agreement (Art. III, Sec. 1) obligated petitioner to pay the 2% amount irrespective of earnings and profits. Even if the provision imposing the obligation could be said to have been intended to deal with the disposition of earnings and profits, as was the Board's view (R. 28), it did not do so "expressly", and Section 26 (c) (2), like other credit provisions, is to be construed strictly. See *Helvering* v. *Northwest Steel Mills,* 311 U. S. 46, 47.

Petitioner concedes (Pet. 2) that the agreement required it to pay the 2% amount irrespective of earnings and profits. But it apparently contends (Pet. 6) that every payment for which a taxpayer would be entitled to a credit under Section 26

(c) (2) must necessarily be required irrespective of earnings and profits, since otherwise the payment would not be for the discharge of a "debt". However, even if it were true that an obligation, to be a "debt", must be payable in any event, petitioner's cause would not be advanced, for, as already said, the statute requires that the contract contain a provision expressly dealing with the disposition of earnings and profits.

2. The credit claimed in No. 660 is for $31,526.66, representing 20% of petitioner's net earnings in 1936 in excess of $320,000. The Board (R. 23–27) and the court below (R. 111–113) sustained the disallowance of this credit on the ground that the trust agreement concededly (R. 25) did not require any of the amount to be paid or set aside "within the taxable year", as specified in Section 26 (c) (2), and on the further ground that, in any event, there was no evidence that petitioner in liquidating its bonded indebtedness had paid any of the amount because of the contract requirement to pay 20% (Art. III, Sec. 1), rather than simply because it chose to exercise its option under the agreement (Art. III, Sec. 3) to redeem the bonds upon 30 days notice. Each of these grounds is well taken and either would alone suffice to defeat the claim.

Petitioner does not mention or make any argument with respect to the second of the foregoing grounds and its contention as to the first is without merit. It states (Pet. 2, 5, 6) that the court

below overlooked the second sentence of Section 26 (c) (2), the implication being, as urged in its petition for rehearing in the court below (R. 116), that the provisions of that sentence, unless nugatory, have the effect of modifying the phrase "within the taxable year", as used in the first sentence, to mean "within the accounting year". Clearly, however, the provisions of the second sentence have no such effect; they merely make the credit available in cases where the contract requires the payment or setting aside within the taxable year of "an amount equal to a percentage of earnings and profits", as well as in the cases covered by the first sentence where the credit is allowed for "the portion of the earnings and profits" required to be paid or set aside within the taxable year.

CONCLUSION

For the reasons stated, the petition for writs of certiorari should be denied.

Respectfully submitted,

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OCTOBER 1941.

APPENDIX

Revenue Act of 1936, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26–2. *Credit in connection with contracts restricting payment of dividends.*—(a) * * * The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

* * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund

sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

* * * * *

U. S. GOVERNMENT PRINTING OFFICE: 1941

IN THE

Supreme Court

OF THE

Guy T. [redacted]

PETITION FOR [redacted]
APPLICATION FOR [redacted]
THE UNITED STATES [redacted]
PEALS FOR THE [redacted]

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IN THE

Supreme Court of the United States

OCTOBER TERM 1941

No. 659
No. 660

MOLONEY ELECTRIC COMPANY, *Petitioner,*

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR RECONSIDERATION OF DENIAL OF APPLICATION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

Your petitioner, Moloney Electric Company, prays that this Court reconsider its denial of application for Writs of Certiorari in these cases for the reason that since the denial of such Writs (November 10, 1941) a conflict of decisions has arisen—the Fourth and Eighth Circuits deciding the question in favor of the Government, and the Sixth Circuit in four cases deciding the question in favor of the taxpayers.

PREVIOUS OPINIONS.

This Court denied Certiorari on November 10, 1941. Prior thereto the Eighth Circuit Court of Appeals decided both questions for the Government (R. 106) (120 Fed. (2d) 617), reversing the United States Board of Tax Appeals on the point decided by that Board in favor of your petitioner, and sustaining the Board on the point it had decided adversely to your petitioners.

The Board of Tax Appeals opinion (R. 15) reported in 42 BTA 78 was accompanied by a dissenting opinion (by two Members) sustaining your petitioner on both points (R. 29) (42 BTA 88).

QUESTIONS PRESENTED.

The two questions presented in the application for Writs of Certiorari rest upon whether a contract executed by your petitioner on June 1, 1928 meets the requirements of Section 26(c)(2) of the Revenue Act of 1936.

STATUTE INVOLVED.

Section 26(c)(2) of the Revenue Act of 1936 allows a credit to corporations in the computation of the Surtax on Undistributed Profits, if a contract was executed prior to May 1, 1936 that required the application of earnings to the liquidation of indebtedness.

STATEMENT.

The application for Writs of Certiorari arise in the determination of petitioner's income tax liability for the year 1936.

The contract in question requires payment of:

(1) Two per cent on the largest amount of bonds outstanding during the year; and

(2) Twenty per cent of the earnings in excess of $320,000.

The Board of Tax Appeals held the 2 per cent payment did meet the requirements of the statute as being part of a contract expressly dealing with the disposition of earnings

and profits of the taxable year; but that the 20 per cent of earnings provision did not meet the requirements of the statute as payment was not required until April 1st of the succeeding year. On the 20 per cent point a dissenting opinion held that the payment date did meet the statutory requirement.

The Eighth Circuit held neither provision came within the statute as the 2 per cent was required to be paid in any event and the 20 per cent payment was not required to be made within the taxable year.

At the time the Eighth Circuit decided the instant case no other circuit had construed the statute.

At the time Certiorari was denied no conflict of decision existed.

On the same day Certiorari was denied (November 10, 1941) the Fourth Circuit decided *Antietam Hotel Corporation* (123 Fed. (2d) 274). In this case the question was similar to the 20 per cent question in the instant case and the Court held in accord with the Eighth Circuit.

On December 9, 1941 the Sixth Circuit decided four cases, involving the same 20 per cent point, contrary to the holdings of the Eighth and Fourth Circuits. The cases are:

Commissioner of Internal Revenue v. *The Strong Manufacturing Company*, No. 8829 (Reported in 1941 Prentice-Hall Federal Tax Service at paragraph No. 63,075).

Commissioner of Internal Revenue v. *The Ohio Leather Co.*, No. 8842 (Reported in 1941 Prentice-Hall Federal Tax Service at paragraph No. 63,-091).

Commissioner of Internal Revenue v. *The Michigan Silica Co.*, No. 8721 (Reported in 1941 Prentice-Hall Federal Tax Service at paragraph No. 63,-092).

Commissioner of Internal Revenue v. *Warren Tool Corporation*, No. 8836 (Reported in 1941 Prentice-Hall Federal Tax Service at paragraph No. 63, 090).

All four decisions are set forth in the Appendix.

The Sixth Circuit in its opinion in *Strong Manufacturing Company* (*supra*) distinguishes its decision from that of the Eighth Circuit in the instant case on three grounds:

(1) "There was no showing in that case (Moloney Electric Company) what the earnings of the corporation were".

The record in the instant case shows (R. 28, 55):

"that $240,000 of its earnings for 1936 was used in liquidating its bonded indebtedness."

(2) "when the payment on the indebtedness was made."

The record in the instant case shows (R. 22):

"They were all retired during that year."

(3) "whether the payment was ever made because of any contract requirement;"

The record in the instant case shows (R. 21):

"Section 1. The Company covenants that as a sinking fund for the retirement of debenture bonds issued hereunder it will pay to the Trustee on the first day of June, 1930, and the first day of each succeeding June thereafter, so long as any of the debenture bonds hereby authorized are outstanding, a sum equal to 2 per cent of the largest amount of debenture bonds at any time outstanding, and will also pay on said date to the said Trustee 20 per cent of the net earnings, for the next preceding year, as hereinafter defined, of the Company in excess of Three Hundred Twenty Thousand Dollars ($320,000). The determination of the sum to be paid to the sinking fund from the net earnings shall be made from an audit to be made at the close of each calendar year by a firm of certified public accountants acceptable to the Trustee, and when said net earnings are so determined from said audit, which, in no event, shall be later than the first day of each April, said amount shall forthwith be set aside in a separate fund by the Company and shall be paid to the Trustee as herein provided on the first day of June of each year, beginning in the year 1930."

REASONS FOR GRANTING THE WRITS.

The Eighth Circuit in deciding the instant case gave no consideration to the second sentence of Section 26(c)(2) of the 1936 Revenue Act which provides:

> "For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be a requirement to pay or set aside such percentage of earnings and profits."

whereas the Sixth Circuit recognized that said sentence was intended to cover situations where, due to a percentage determination, the amount could not be determined until after the last day of the year, stating: (*Strong Manufacturing Company, supra*)

> "Obviously, the result would be to deny such credits to practically all manufacturing and merchandising corporations, and to admit only those financial companies whose earnings and profits are generally susceptible of immediate computation. This would be unjust."

A conflict exists between the Circuits as to the construction and scope of Section 26(c)(2) which should be resolved by this Court, and unless on reconsideration the Writs are granted this petitioner will forever lose its rights.

CONCLUSION.

Wherefore, it is prayed that this Court will reconsider its denial of the application for Writs of Certiorari and on reconsideration grant such Writs to the end that petitioner may have such relief in the premises as to this Court may seem proper.

DONALD A. CALLAHAN,
Attorney for Petitioner.

Of Counsel:
CARL J. BATTER,

January 6, 1942.

APPENDIX.

Commissioner of Internal Revenue v. The Strong Manufacturing Company.

(U. S. Circuit Court of Appeals, Sixth Circuit, No. 8829, December 9, 1941)

On Petition for Review of Decision of the United States Board of Tax Appeals.

Before Hamilton, Martin and McAllister, Circuit Judges.

McAllister, Circuit Judge.

The Commissioner of Internal Revenue filed his petition for review of the decision of the Board of Tax Appeals that The Strong Manufacturing Company was entitled to a credit on its 1936 surtax on undistributed profits by virtue of Section 26(c)(2) of the 1936 Revenue Act.

The above mentioned section of the act in so far as here applicable, provided that credits on undistributed profits shall be allowed to a corporation to the extent that earnings and profits are required to be irrevocably set aside within the taxable year for the discharge of a debt, provided they are so required to be set aside by written contract executed by the corporation prior to May 1, 1936. The taxpayer, an Ohio corporation, purchased its plant and equipment from the Central United National Bank of Cleveland about April 15, 1932, for the sum of $50,000. The purchase price was evidenced by a note, secured by a mortgage executed by the taxpayer to the bank, providing for payment in eight installments of varying amounts, due on April 15, 1934, and on the same date of each year thereafter. Stipulations in the note set forth that the corporation could anticipate unpaid installments in whole or in part; and it was further provided in the note:

"In addition The Strong Manufacturing Company shall apply forty per cent (40%) of its net earnings in and for any calendar year beginning January 1, 1934, upon the unpaid balance of said purchase price, provided that the amount so applied shall never be less than the installment of the purchase price specified for payment in such year, all as more fully set forth in said mortgage deed."

The mortgage set forth:

"The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been

fully paid and beginning on January 1st, One Thousand nine hundred thirty four, the Company will apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment by the terms of said note nor of the regular interest payments in such year, likewise as specified in said note."

It was further provided that if the corporation defaulted, and such default continued for thirty days, the bank could declare the entire balance immediately due and payable; and no waiver of any default by the bank should affect any subsequent default.

In 1934, the taxpayer obtained from the bank a written extension on a then due installment of $2,000, principal, and $3,500, interest, on the note and mortgage. The extension was on the specific condition that it should not be considered a waiver of any subsequent defaults; and the bank did not waive or make any concession in respect to the covenants of the note and mortgage requiring the taxpayer to apply 40% of its net earnings in payment of the debt.

During 1936, the taxpayer made payments out of profits on the principal of the note, in various months, aggregating $46,500, whereupon the bank waived payment of a small amount of principal and some interest, and accepted such payments in full for the balance due on the note and mortgage. The taxpayer claimed that these aggregate payments on the note and mortgage, which it made in 1936, are entitled to credit on undistributed profits and that by virtue of the provisions of the act, it is not taxable thereupon.

The relevant provisions of the statute read:

"In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

(c) Contracts Restricting Payment of Dividends.

(2) Disposition of profits of Taxable Years.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written

contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936."

Petitioner insists that the contract did not require that respondent irrevocably set aside a portion of its earnings of the taxable year within that year for the discharge of the debt; and that inasmuch as the contract did not come within the required terms of the statute, respondent is entitled to no credit for the payments made.

The question, therefore, before us for determination, is whether the payments made by the corporation upon its debt are taxable as undistributed profits, or whether it is entitled to credit on the basis of earnings and profits "irrevocably set aside within the taxable year for the discharge of a debt."

In brief, the statute allows a deduction on the tax in question where a contract requires a corporation to set aside irrevocably a portion of its profits within the taxable year for the payment of a debt. In this case, the contract of the corporation requires it to apply 40% of its net earnings for any calendar year to pay the balance of the debt, or a portion thereof, in that year. It is contended on behalf of the Commissioner that, because settlement on the debt could be made in the succeeding year, the contract does not require the irrevocable setting aside of such profits in the year in which they are earned. On the other hand, respondent corporation contends that, inasmuch as it is bound to "apply" its profits for the calendar year to the payment of the balance of the debt remaining unpaid in that year, this obligation comes within the requirement of the statute and constitutes a contract to set aside irrevocably a portion of its profits to the payment of a debt within a taxable year.

The phrase "set aside" has various meanings and connotations. One is "reserve' and "reserve" is defined as "to keep back," "to retain," "to keep in store for future

or special use," and "to retain or hold over to a future time"; "irrevocable" is defined as "incapable of being recalled or revoked." Webster's New International Dictionary. To sustain the respondent, we are required, however, to construe the statute to the effect that "to set aside" means: to place in a separate fund; to carry under a separate entry or in a separate account; to transfer to a trustee; or some equivalent act of physical separation or appropriation of the profits, for the payment of the debt. If the statute provided that the corporation would be entitled to credit by virtue of a provision of a contract requiring it to keep, retain or reserve, without right of revocation, a portion of its profits within the taxable year for the discharge of a debt, it would seem that respondent would be entitled to credit on the tax. Whether such a construction can properly be given the statute, and whether the conclusion reasonably follows that respondent is entitled to credit, depends upon accepted rules of statutory construction.

The construction of the statute for which the Commissioner contends would forbid credits to any corporation whose business was such that it could not definitely ascertain its profits on the last day of the year; and this would exclude from such benefits all corporations that were obliged to take an inventory that could not be completed within the year. Obviously, the result would be to deny such credits to practically all manufacturing and merchandising corporations, and to admit only those financial companies whose earnings and profits are generally susceptible of immediate computation. This would be unjust. Payment of the high surtax would work an unusual hardship on a corporation that was required, under penalty of mortgage foreclosure, to pay such earnings on its mortgage debts. Furthermore, the result of sustaining the claim of the Commissioner would be to require payment of a surtax on undistributed profits where there were no undistributed profits, by reason of the fact that the earnings, under inexorable conditions of a contract, were required to be paid upon a debt. This would be unjust and result in a burden of an especial and unusual nature.

Where a particular construction of a statute will produce inequality and injustice, that view is to be avoided if another and more reasonable interpretation is present in the statute. Constantine v. United States, 75 F. (2d) 928, Aff., 296 U. S. 287. The strict letter must yield to the evi-

dent spirit and purpose when necessary to give effect to the intent of Congress; Fleischmann Const. Co. v. United States, to use of Forsberg, 270 U. S. 349; for a thing which is within the intention of the statutes is as much within the statute as if it were within the letter, and a thing which is within the letter of the statute is not within the statute, unless it is within the intention of the maker; Northwestern Mutual Life Insurance Co. v. Gridley, 100 U. S. 614; and where the meaning is uncertain, a statute will be construed so as to avoid unnecessary hardship. Burnet v. Guggenheim, 288 U. S. 280. The duty of the court, being satisfied with the intention of the legislature, is to give effect thereto and not to defeat it by adhering too rigidly to the mere letter of the statute or to technical rules of construction. Oates v. First National Bank, 100 U. S. 239.

In the application of taxing statutes, substance and not form should control; Sanborn v. Commissioner of Internal Revenue, 88 F. (2d) 134, cer. den., 301 U. S. 700; and such laws should be construed and applied with a view of avoiding, as far as possible, unjust consequences. Farmers Loan and Trust Co. v. State of Minnesota, 280 U. S. 204.

In ascertaining the purpose of the legislature in enacting a statute, the court may examine its title and the legislative scheme or plan by which the object of the act is to be carried out; United States v. Katz, 271 U. S. 354; and the intention is to be ascertained, not by taking a word or clause from its setting and viewing it apart, but by considering it in connection with the context, general purpose of the statute, occasion and circumstances of its use, and other appropriate tests for the ascertainment of the legislative will. Helvering v. Stockholms Enskilda Bank, 293 U. S. 84. The purpose of all statutory construction is to give effect to the legislature's intention and, hence, no rule of strict construction, which will defeat a statute's purpose, can be applied to its bare language.

The general title of the 1936 Revenue Act sets forth its purpose to "provide revenue, equalize taxation, and for other purposes." The subtitle of Section 26(c) of the act reads: "Contracts restricting payment of dividends," and the title of Sub-section 26(c)(2) is: "Disposition of profits of taxable year." In the message of the President to Congress with respect to the enactment of the statute, the provisions of which are under consideration, he directed attention to a form of tax for the purpose of removing in-

equalities in the tax system, and mentioned in this regard, the accumulation of surplus in corporations and the freedom of such undistributed corporate income from surtax. Message of President to Congress, March 3, 1936. In the report of the Ways and Means Committee of the House of Representatives on the Revenue Bill of 1936, after quoting the message, the Committee stated that the President had requested Congress to raise additional revenue by some form of undistributed profits tax, and that the Committee recognized that the greatest defect in the system of taxation at that time lay in the fact that surtaxes on individuals were avoided by impounding income in corporate surpluses. It was further recommended that corporations should not be permitted to withhold from the beneficial shareholders unneeded corporate income at the expense of the revenue of the United States and to the detriment of the shareholders, H. R. Rept. No. 2475, 74th Congress, Sec. Sess. From these proceedings, the legislative intention and the general purpose of the act, are obvious. It was sought to prevent corporations from accumulating tax free surplus arising out of their failure to distribute the earnings to shareholders, with the result that the Government could not tax such individuals. The headings in the statute, above referred to, indicate the intent to grant credit on surtax imposed on undistributed profits to the extent that such profits were not declared as dividends by reason of a contract requiring a different disposition of such profits.

It is necessary to keep in mind that taxation is an intensely practical matter and the substance of the thing done, and not the form it takes, must govern. Commissioner of Internal Revenue v. Ashland Oil and R. Co., 99 F. (2d) 588 (C. C. A. 6); and that common sense interpretation is the safest rule to follow in the administration of income tax laws. "Gross income and deductions flow from trade, commerce and dealings in property carried on in the ordinary business way and in the determination of taxes, men should measure both by ordinary, every-day business standards." Rhodes v. Commissioner of Internal Revenue, 100 F. (2d) 966, 969 (C. C. A. 6).

With reference to the object of the statute to equalize taxation, it cannot be said that the resulting inequality of taxation, as contended for on behalf of the Commissioner, is consonant with such expressed purpose. There appears to be no reason founded on principles of fair dealing, ac-

counting methods, ordinary business practice, or common sense, that would justify the unreasonable, capricious, and discriminatory plan of taxation, here sought to be established as the statutory law; and, in this case, in the absence of a clearly expressed intention to the contrary, it must be held that Congress did not intend to work inequality, injustice, and hardship, nor was it intended that the statute would have this meaning and effect.

We are of the opinion that, in accordance with the legislative intent, the contract, requiring the corporation to "apply" 40% of its earnings for any calendar year to the payment of indebtedness in such year, is encompassed by the requirement of Section 26(c)(2) of the Revenue Act of 1936; and such application is equivalent to setting aside, irrevocably, profits within the taxable year for the discharge of a debt, and entitles the taxpayer to credit.

That the profits, which were required to be applied to the indebtedness, could not be computed until after the taxable year, casts no doubt upon the conformity of the contract to the requirements of the statute. Where the law requires debts to be charged off within the taxable year, in order to receive deductions, the statutory language is construed to allow deductions for debts *physically* charged off in the first months of the succeeding year, in recognition of practical business necessities; and it is held that Congress did not intend that there should be any essential departure from the usual course of business in making book entries in order to comply with tax laws. Hamlen v. Welch, 116 F. (2d) 413 (C. C. A. 1); Kentucky Rock Asphalt Co. v. Helburn, 20 F. Supp. 364, aff., 108 F. (2d) 779 (C. C. A. 6). Like principles are applicable to the ascertainment of profits, and credit for applications thereof on indebtedness.

The claim is advanced that because the duty to make certain regular stipulated payments did not, by contract, depend on the existence of earnings, therefore, the taxpayer is not entitled to credit for such payments on the indebtedness. But the taxpayer is only seeking credit for that amount of profits which, in accordance with the contract, it claims it irrevocably set aside for payment of the debt. If the contract with respect to the setting aside of such profits, conforms to the requirement of the statute, it is immaterial that the portion of profits so set aside for the indebtedness, exceeded the stipulated sum which was required to be paid, regardless of profits. That such re-

quired payment was included in the percentage of profits required to be set aside, has no bearing upon the right to credit.

We are mindful of the fact that since the argument in the instant case, in Antietam Hotel Corp. v. Commissioner of Internal Revenue, 123 F. (2d) 274 (C. C. A. 4) [¶ 63,010] (decided November 10, 1941), it was held "that as an indispensable condition precedent to the allowance of the credit, the contract must in terms require that a part of the earnings and profits of the taxable year be * * * irrevocably set aside within the taxable year." We do not arrive at the same conclusion, for we do not find from the language of the statute that the contract must require the earnings to be irrevocably set aside, *in terms*. With regard to the case of Helvering v. Moloney Electric Co., 120 F. (2d) 617 (C. C. A. 8), in which it was held that the taxpayer was not entitled to credit under the section of the statute in question, it appears that there was no showing in that case what the earnings of the corporation were, when the payment on the indebtedness was made, or whether the payment was ever made because of any contract requirement; and these circumstances were of paramount significance in that adjudication. Confronted by entirely different facts, it would appear that further discussion, for the purpose of distinguishing the cited case, would be fruitless.

In accordance with the foregoing, the decision of the Board of Tax Appeals is affirmed.

Commissioner of Internal Revenue v. Warren Tool Corporation.

(U. S. Circuit Court of Appeals, Sixth Circuit, No. 8836, December 9, 1941).

Before: Hamilton, Martin and McAllister, Circuit Judges.

Order.

McAllister, J.:

This cause was heard upon the transcript of the record, briefs and arguments of counsel, and on consideration whereof,

It is ordered, adjudged and decreed that the order of the Board of Tax Appeals be and the same is affirmed in accordance with our opinion in Commissioner of Internal Revenue v. Strong Manufacturing Company, — Fed. (2d) —, this day decided.

Commissioner of Internal Revenue v. The Ohio Leather Company.

(U. S. Circuit Court of Appeals, Sixth Circuit, No. 8842, December 9, 1941).

Before: Hamilton, Martin and McAllister, Circuit Judges.

Order.

McAllister, J.:

This cause was heard upon the transcript of the record, briefs and arguments of counsel, and on consideration whereof,

It is ordered, adjudged and decreed that the order of the Board of Tax Appeals be and the same is affirmed in accordance with our opinion in Commissioner of Internal Revenue v. Strong Manufacturing Company, — Fed. (2d) —, this day decided.

Commissioner of Internal Revenue v. Michigan Silica Company.

(U. S. Circuit Court of Appeals, Sixth Circuit, No. 8721, December 9, 1941).

Before: Hamilton, Martin and McAllister, Circuit Judges.

Order.

McAllister, J.:

This cause was heard upon the transcript of the record, briefs and arguments of counsel, and it appearing that the provisions of respondent's contract, herein concerned, expressly deal with the disposition of the gross income of respondent and, therefore, necessarily deal with the disposition of the earnings and profits within the taxable year, as required for credit on undistributed profits tax under Section 26(c)(2), of the Revenue Act of 1936,

It is ordered, adjudged and decreed that the order of the Board of Tax Appeals be and the same is hereby affirmed. See Commissioner of Internal Revenue v. Strong Manufacturing Company, — Fed. (2d) —, this day decided.